



Stepan Co. (SCL)

Updated August 4th, 2019 by Josh Arnold

Key Metrics

Current Price:	\$96	5 Year CAGR Estimate:	0.2%	Volatility Percentile:	73.7%
Fair Value Price:	\$75	5 Year Growth Estimate:	4.0%	Momentum Percentile:	58.7%
% Fair Value:	128%	5 Year Valuation Multiple Estimate:	-4.8%	Growth Percentile:	24.9%
Dividend Yield:	1.0%	5 Year Price Target	\$91	Valuation Percentile:	21.1%
Dividend Risk Score:	A	Retirement Suitability Score:	C	Total Return Percentile:	7.8%

Overview & Current Events

Stepan Co. was founded in 1932 and at the outset, it sold only one product; a chemical to keep dust down on Illinois' country roads. Since that time, it has grown to manufacture basic and intermediate chemicals, with surfactants making up most of its total revenue. It has a market capitalization of \$2.2 billion after a recent rally, and should do just under \$2 billion in revenue this year.

Stepan reported Q2 earnings on 7/24/19 and results were mixed as revenue was weak, but earnings performed well. Total revenue was down 9% year-over-year as global sales volume fell 5%. In addition, forex translation weighed on the top line, and lower selling prices crimped the top line due to the pass-through of lower raw material costs.

Surfactants revenue plummeted 12% in Q2 as it remains Stepan's weakest business by a wide margin. Of note, it is also roughly three-quarters of the company's revenue, so it is tremendously important to Stepan's results. We note this decline is a marked acceleration of the weakness the surfactants business showed in Q1. We see the material weakness in Surfactants in Q2 as a significant warning sign for investors given volume, as well as pricing/mix, declined.

The Polymers segment stabilized in Q2 as it showed flat year-over-year revenue, a slight improvement over Q1. Specialty Products, which is just a fraction of total revenue, saw its revenue decline 14% in Q2.

Operating margins rose significantly in Q2 despite light revenue, and produced stronger earnings for Stepan as a result. Surfactants operating income fell 6%, but that was just half of the decline of revenue in that segment. Polymers operating income actually rose 12% in Q1, while Specialty Products saw its operating income increase 41%. In total, operating income at the segment level was up 4% year-over-year, helping to salvage what was a very weak quarter in revenue terms for Stepan.

Stepan's net income in dollar terms fell 10% year-over-year, but the company recently changed the way it values inventory, and on an adjusted basis, earnings-per-share rose 8% from \$1.39 to \$1.50 as a result. We have left our estimate for earnings-per-share this year unchanged at \$5.00, but note that Stepan's accounting changes won't apply in future years. Fundamentally, the company isn't performing very well and investors should be cautious.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
EPS	\$2.92	\$2.95	\$3.21	\$3.49	\$3.18	\$2.49	\$3.32	\$3.73	\$3.92	\$4.88	\$5.00	\$6.08
DPS	\$0.45	\$0.49	\$0.53	\$0.58	\$0.65	\$0.69	\$0.73	\$0.78	\$0.86	\$0.93	\$1.00	\$1.30
Shares	20	20	20	22	22	22	22	22	23	23	24	25

Stepan's earnings have been somewhat inconsistent, but over time have grown at decent rates. The company is beholden to the world's manufacturers, so any sort of economic weakness can have severe consequences on earnings. It does boast a wide and deep array of customers, so concentration is not a problem, but as we've seen with the polymers business recently, weakness in just one business line can cause Stepan's results to vary widely from one year to another.

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We are forecasting a five-year average earnings-per-share growth rate of 4%, consisting of mid-single digit sales growth and slightly weaker margins over time. The company's cost-saving program has been in place for some time and has yielded operating margin gains, but those gains appear to be plateauing.

The company's dividend has grown steadily in the past decade. However, the payout is less than a quarter of earnings and the high valuation in the stock has led to a current yield of just 1.0%. We expect the payout will rise by ~5% annually as acquisitions and R&D take priority.

Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	8.0	10.9	11.3	13.2	18.6	21.0	14.0	16.3	19.1	16.5	19.2	15.0
Avg. Yld.	1.9%	1.5%	1.5%	1.3%	1.1%	1.3%	1.6%	1.3%	1.2%	1.1%	1.0%	1.4%

Stepan's price-to-earnings multiple remains stubbornly high. The company's multiple could come back to more normalized levels over time and we are forecasting a sizable 4.8% headwind to annual total returns for the next five years. While the valuation has come off of its recent highs, it is still at 128% of our estimate of fair value.

The yield is likewise showing that Stepan is overvalued relative to its history. We see the stagnant stock price and a rising payout moving the yield up to 1.4% in five years' time, up from the current 1.0%.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	15%	16%	16%	16%	20%	27%	21%	21%	22%	19%	20%	21%

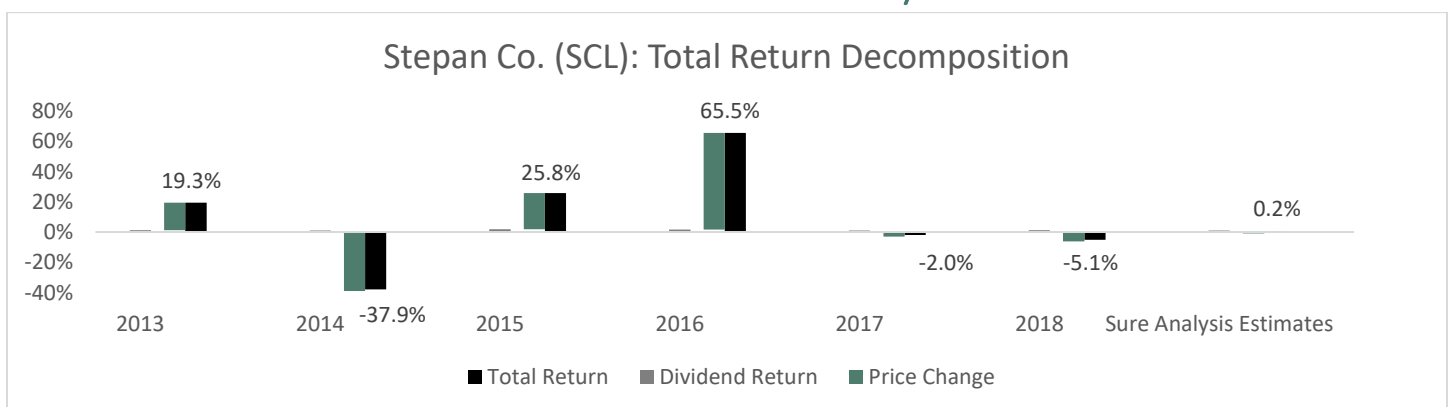
Stepan's payout ratio is just one-fifth of earnings, and we don't see it moving from there given the company's focus on investing in future growth rather than paying cash out to shareholders.

The company's competitive advantage is in its diverse, global customer base and many decades of engineering experience. Stepan's competitors cannot easily supplant its position with existing customers given the often-custom nature of what Stepan engineers for them. However, Stepan is certainly not immune to economic weakness and as we've seen, its earnings-per-share history shows that results can bounce around from one year to another.

Final Thoughts & Recommendation

Stepan is still trading well in excess of our estimate of fair value. We are forecasting total annual returns for the next five years of just 0.2%, comprised of the 1.0% current yield, 4% earnings-per-share growth and a 4.8% headwind from the valuation reset. Stepan's growth outlook has deteriorated somewhat due to the surfactants business, but the soaring valuation is the principal issue today. We see the stock as very unattractive, and continue to rate it a sell.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue	1276	1431	1843	1804	1881	1927	1776	1766	1925	1994
Gross Profit	233	236	256	292	282	250	308	339	339	342
Gross Margin	18.3%	16.5%	13.9%	16.2%	15.0%	12.9%	17.4%	19.2%	17.6%	17.1%
SG&A Exp.	92	90	97	117	125	109	138	150	136	134
D&A Exp.	37	40	47	51	56	64	67	75	79	81
Operating Profit	105	108	118	129	110	95	120	133	149	153
Operating Margin	8.2%	7.5%	6.4%	7.1%	5.9%	4.9%	6.8%	7.5%	7.8%	7.7%
Net Profit	63	65	72	79	73	57	76	86	92	113
Net Margin	4.9%	4.6%	3.9%	4.4%	3.9%	3.0%	4.3%	4.9%	4.8%	5.7%
Free Cash Flow	124	-8	-6	26	57	-19	64	109	120	84
Income Tax	34	36	32	36	23	18	27	28	48	27

Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Assets	634	811	901	985	1167	1162	1238	1354	1471	1485
Cash & Equivalents	99	111	84	77	133	85	176	226	299	300
Accounts Receivable		199	261	256	266	270	250	263	294	280
Inventories	75	97	111	162	172	183	170	174	173	200
Goodwill & Int. Ass.	9	12	18	16	35	32	29	48	44	37
Total Liabilities	344	458	496	505	613	625	680	718	730	700
Accounts Payable	95	115	138	142	157	157	129	158	205	206
Long-Term Debt	104	192	199	182	271	274	331	317	291	276
Shareholder's Equity	276	336	388	477	552	536	557	635	740	784
D/E Ratio	0.36	0.55	0.50	0.38	0.49	0.51	0.59	0.50	0.39	0.35

Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Return on Assets	10.1%	9.1%	8.4%	8.4%	6.8%	4.9%	6.3%	6.6%	6.5%	7.6%
Return on Equity	26.8%	21.4%	19.9%	18.3%	14.1%	10.5%	13.9%	14.5%	13.3%	14.8%
ROIC	16.9%	13.9%	12.5%	12.5%	9.8%	7.0%	8.9%	9.4%	9.2%	10.8%
Shares Out.	20	20	20	22	22	22	22	22	23	23
Revenue/Share	59.11	64.52	82.13	79.35	82.04	84.10	77.70	76.48	82.35	85.48
FCF/Share	5.73	-0.34	-0.26	1.14	2.51	-0.84	2.82	4.72	5.14	3.62

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.

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